Searching for Expansionary Austerity

Michael Konczal
Roosevelt Institute
9/21/2015

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Original Situation

- Alberto Alesina and Silvia Ardagna: “in several episodes, spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions.”

- “Some theorists will tell you that if governments shift their emphasis to deficit cutting, they risk sending the world back into recession. There are some reasons to think this is so, but events tell a more complicated story.

  Alberto Alesina of Harvard has surveyed the history of debt reduction. He’s found that, in many cases, large and decisive deficit reduction policies were followed by increases in growth, not recessions. Countries that reduced debt viewed the future with more confidence. The political leaders who ordered the painful cuts were often returned to office.” - David Brooks, “Prune and Grow”, *New York Times*, June, 2010.

- “This is Alesina's hour. In April in Madrid, he told the European Union's economic and finance ministers that "large, credible, and decisive" spending cuts to reduce budget deficits have frequently been followed by economic growth. He backed his proposal with historical research on rich countries' experiences since 1980.” Peter Coy, “Keynes vs. Alesina. Alesina Who?”, *Bloomberg Business*, June 2010.

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Original Research

- A & A use a panel of twenty OECD countries from 1970 to 2007.
- Capture years in which the primary deficit decreased by at least 1.5 percent of GDP. This gives them 107 periods.
- Compare the growth rates between the deficit decrease and the overall G7, taking the 25% largest differences. This gives them 26 periods.
- Ensure that the debt-to-GDP ratio has fallen 4.5 percent. This gives them 17 out of 26 periods as “succesful.”

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Initial Response

- Some obvious problems:
  - Endogeneity of deficit reduction.
  - Can’t tell whether or not the primary deficit is being decreased at the height of a boom or at the bottom of a slump.
    - Narrative approaches (Romer and Romer 2007) one way to solve problem.
- The economy need not be growing quickly (or indeed at all) for this to happen.

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Formal Response

- “The Boom Not The Slump: The Right Time For Austerity”

- The boom, not the slump, is the right time for austerity at the Treasury.” - John Maynard Keynes (1937)

  - (Perhaps not even then?)

- Did they cut in a slump? And is growth higher after compared to before?

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Table 1: A & A's Cases of Expansionary Fiscal Consolidation

Country	Year	Real GDP Growth Year T	Real GDP Growth Rate in Year T-1	Average Growth Rate T-3 to T-1	Average Growth Rate from T to T+2	Average Growth Rates from (T to T+2) - (T-3 to T-1)	Do they cut in a slump? (Growth T-1 below average of T-3 to T-1?)	Is Average Growth Higher in Post Adjustment than Pre-Adjustment?
Spain	1986	3.3	2.3	2.0	4.6	2.7	No	Yes
Spain	1987	5.5	3.3	2.5	5.1	2.7	No	Yes
Finland	1973*	7	7.7	5.1	4.0	-1.1	No	No
Finland	1996	3.7	3.9	2.2	5.0	2.8	No	Yes
Finland	1998	5.2	6.2	4.6	4.7	0.1	No	Yes
Finland	2000	5.1	3.9	5.1	3.1	-2.0	Yes	No
Greece	1976	6.9	6.4	2.7	5.7	3.0	No	Yes
Greece	2005	2.2	4.6	4.6	3.7	-0.9	Yes	No
Greece	2006	4.5	2.2	4.2	3.7	-0.6	Yes	No
Ireland	1976	1.4	5.7	4.9	5.6	0.7	No	Yes
Ireland	1987	4.7	-0.4	2.4	5.2	2.9	Yes	Yes
Ireland	1988	5.2	4.7	2.5	6.5	4.0	No	Yes
Ireland	1989	5.8	5.2	3.2	5.4	2.2	No	Yes
Ireland	2000	9.4	10.7	10.2	7.2	-3.0	No	No
Netherlands	1996	3.4	3.1	2.5	3.9	1.4	No	Yes
Norway	1979	4.4	3.9	4.6	3.5	-1.1	Yes	No
Norway	1980	4.5	4.4	4.1	2.0	-2.1	No	No
Norway	1983	3.9	0.1	2.0	5.1	3.0	Yes	Yes
Norway	1996	5.1	4.2	4.0	4.4	0.4	No	Yes
New Zealand	1993**	6.4	1.1	0.1	5.3	5.2	No	Yes
New Zealand	1994	5.3	6.4	2.1	4.3	2.3	No	Yes
New Zealand	2000	2.4	5.3	2.5	3.6	1.1	No	Yes
Portugal	1986	4.1	2.8	0.2	6.0	5.8	No	Yes
Portugal	1988	7.5	6.4	4.4	6.0	1.5	No	Yes
Portugal	1995	4.3	1	0.0	4.0	4.0	No	Yes
Sweden	2004	4.1	1.9	1.8	3.9	2.1	No	Yes

Formal Response

- Of the 26 episodes that they identify as ‘expansionary’, in virtually none did the country:
  - a) reduce the deficit when the economy was in a slump
  - b) increase growth rates while reducing the debt-to-GDP ratio.
- Their examples of successful consolidation were, on average, growing strongly the year before the year of adjustment.

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Formal Response

- There were two that did, Ireland (1987) and Norway (1983).
    - Norway (1983) wasn't successful in their definition, because their debt to GDP ratio increased.
    - In 1983, the year of consolidation, the debt was 20.83% of GDP. This rose about 14% to 34% of GDP by 1986.

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Formal Response

- There were two that did, Ireland (1987) and Norway (1983).
    - Ireland (1987) saw a massive exchange rate devaluation, while its closest trading partner went under a once-in-a-decade boom.
    - Also saw a decline of about 5% in the interest rate differential between it and the benchmark interest rates over the course of a year.

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All Cases

Table 5: Cases Where Fiscal Consolidation Occurred in A Slump, Growth Increased and Government Debt-to-GDP Ratios Fell.

Country	Years
Australia	1987
Belgium	2006
Canada	1997
Ireland	1987
Norway	1989, 2004
Sweden	1986, 1997
Total Cases	8

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All Cases

- Of these only two, Norway in 1989 and Ireland in 1987, are examples that approximate the U.S. experience today, in that they both experienced recessions in the year prior to consolidation.

- Norway show, 1989 was the first year of a very strong expansionary policy in Norway as a reaction to the recession of 1988. They note that between 1988 and 1991, “The cyclically adjusted primary deficit increased by 3.8 per cent of trend GDP”.

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The Response

- “In addition, what is unfolding currently in Europe directly contradicts Jayadev and Konczal. Several European countries have started drastic plans of fiscal adjustment in the middle of a fragile recovery.

  At the time of this writing, it appears that European speed of recovery is sustained, faster than that of the U.S., and the ECB has recently significantly raised growth forecasts for the Euro area.”
  - Alesina, September 2010

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Austerity 2009-2011	Real GDP Growth, 2008-2010	Real GDP Growth, 2011-2014	Debt/GDP Increase 2010-2014	Had Austerity 2009-2011?	Grew Faster Afterwards?	Reduced Debt/ GDP?
Czech Republic	-0.006816938	0.177343192	10.76549531	Yes	Yes	No
Estonia	-5.863214118	4.848149772	2.325278017	Yes	Yes	No
Greece	-3.378380558	-6.48776816	55.40217374	Yes	No	No
Hungary	-1.648458079	0.558623291	13.26986341	Yes	Yes	No
Iceland	-2.35532672	2.423716116	-5.384523914	Yes	Yes	Yes
Ireland	-3.121448416	0.89443002	32.71249953	Yes	Yes	No
Italy	-1.629797238	-1.272826842	32.41835221	Yes	Yes	No
Netherlands	-0.081036621	-0.179603757	14.11449487	Yes	No	No
Poland	3.417800304	2.750447597	4.786626981	Yes	No	No
Portugal	-0.293379906	-2.486629729	46.34513214	Yes	No	No
Slovenia	-1.091822239	-1.008351317	51.02057426	Yes	Yes	No
Spain	-0.814684532	-1.312117406	49.10060915	Yes	No	No
United Kingdom	-0.910447124	1.32301383	24.06905052	Yes	Yes	No

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